No. 83-26

IN THE

Supreme Court of the United States

OCTOBER TERM, 1983

DONALD I. LAVENTHALL,

Petitioner,

v.

GENERAL DYNAMICS CORPORATION,

Respondent.

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF IN OPPOSITION

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STATEMENT REQUIRED BY RULE 28.1

Respondent General Dynamics Corporation has the following affiliated corporations, companies and partnerships: Lachmar Partnership; Mansour-G.D. Ltd.; Mines SNA, Inc./SNA Mines, Inc.; and Etudes Techniques et Constructions Aerospatiales, Societe Anonyme. General Dynamics has no parent corporation and no subsidiary which is not wholly owned.

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OPINIONS BELOW

The opinion of the court of appeals (Pet. App. 1a-14a) is reported at 704 F.2d 407. The opinion of the district court (Pet. App. 16a-19a) is not officially reported.

JURISDICTION

The judgment of the court of appeals was entered on April 6, 1983. The petition for certiorari was mailed for filing on July 5, 1983. This Court's jurisdiction is invoked under 28 U.S.C. § 1254(1).

STATUTE AND RULE INVOLVED

Section 10(b) of the Securities Exchange Act of 1934, 15 U.S.C. § 78j(b) (1976), provides in part:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

Rule 10b-5 of the Securities Exchange Commission, 17 C.F.R. § 240.10b-5 (1982), provides:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

STATEMENT OF THE CASE

On October 13, 1978, Donald Laventhall purchased ten call options for 1000 shares of common stock of General Dynamics Corporation on the Chicago Board of Options Exchange. (Pet. App. 2a.) The complaint did not allege that Laventhall owned, purchased, or sold General Dynamics stock at any time. The call options did not represent an investment in any corporation. (Pet. App. 6a.) General Dynamics had no power to control or consent to the issuance, sale, or listing of options for trading against its common stock. (Pet. App. 6a.) Call options traded on the Chicago Board of Options Exchange are not securities of General Dynamics; they are securities of the Options Clearing Corporation, a Delaware corporation equally owned by five national options exchanges and having no relationship to General Dynamics. (Pet. App. 5a-6a; R. 46, 47.) Laventhall sold his call options on the morning of January 4, 1979, without exercising them. (Pet. App. 4a.)

Laventhall filed this purported class action on behalf of himself and all persons who sold call options or "other securities" of General Dynamics Corporation during the period from December 6, 1978 to January 4, 1979. (Pet. App. 2a.) In December 1978, General Dynamics purchased 157,500 shares of its common stock for its Management Incentive Program. (Pet. App. 2a.) It neither purchased nor sold any options on the Chicago Board of Options Exchange. Laventhall alleged that the management of General Dynamics also considered issuing a cash dividend on its common stock during the class period. (Pet. App. 16a-17a; R. 3.) On January 4, 1979, General Dynamics declared a cash dividend of $3.00 per share on its common stock. (Pet. App. 3a, 17a.)

In the order on which certiorari is sought, the district court dismissed the complaint as to Laventhall and all call option holders on the ground that under this Court's ruling in *Chiarella* v. *United States*, 445 U.S. 222 (1980), the complaint failed to assert the fiduciary or similar relationship of

trust and confidence required to impose upon General Dynamics a duty to disclose the alleged inside information to call options traders. (Pet. App. 18a.) The district court gave Laventhall an opportunity to present evidence suggesting a class action would still be appropriate. (Pet. App. 19a.) When no evidence was produced, and no shareholder came forward to assert a claim, the court issued a separate order, not challenged by Laventhall (Pet. 1), dismissing the class action because Laventhall was not an adequate representative of the remaining class. 91 F.R.D. 208 (1981).

The Eighth Circuit Court of Appeals affirmed the dismissal of the complaint. (Pet. App. 1a-14a.) It held that on the facts of this case, there was neither the requisite fiduciary relationship under *Chiarella*, nor any transactional nexus between Laventhall's trading on the Chicago Board of Options Exchange and General Dynamic's alleged failure to disclose information when it traded in its own common stock on the New York Stock Exchange. (Pet. App. 8a-14a.) Under these circumstances, the court of appeals found General Dynamics did not have a duty of disclosure to options traders and that its alleged illegal gain was remote and totally speculative in relation to Laventhall's loss in a different market. (Pet. App. 10a.)

REASONS FOR DENYING THE WRIT

I.

THE DECISION BELOW IS CLEARLY CORRECT UNDER CHIARELLA AND DIRKS

Petitioner argues that the decision below authorizes unlawful insider trading in options, creating a "loophole" in the securities laws. (Pet. 7, 9–11.) The petitioner's argument lacks merit because it depends upon an overstatement of the holding of the Eighth Circuit in this case. Contrary to petitioner's assertions (Pet. App. 7 n. 6), the court of appeals did not hold that a trader in options would be precluded from bringing a Section 10(b) claim against an insider trading in

options on the basis of material inside information. Its holding was limited to the facts presented: when the defendant has no fiduciary or other confidential relationship with the plaintiff and has not traded with the plaintiff (under any standard of proof), the plaintiff cannot state a claim for relief under Section 10(b) of the Securities Exchange Act or Rule 10b-5.[1]

The holding in this case is not only consistent with the decisions of this Court, but to have ruled as Laventhall urged would have required a significant expansion of the securities laws. No decision by this Court nor any circuit court of appeals has upheld a complaint for civil damages where there was neither a fiduciary relationship nor a transactional relationship between the plaintiff and the defendant.[2]

The Eighth Circuit correctly held that General Dynamics had no duty to disclose information to those who traded in options which it did not issue or authorize. The petitioner

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[1] The standards of proof for establishing a transactional relationship vary, but require at least a showing that plaintiff and defendant traded contemporaneously in the same securities on the same market. E.g., *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 241 (2d Cir. 1974); *Fridrich* v. *Bradford*, 542 F.2d 307, 318-319 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977); Pet. App. 9a-10a.

[2] In *O'Connor & Assocs.* v. *Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 803-04 (S.D.N.Y. 1983), the Court permitted options traders to sue insiders *who traded in options* during the same period. (An earlier decision in the same case is cited, Pet. 12.) Only one district court has upheld a complaint by options traders against an insider trading only in stock. *Backman* v. *Polaroid Corp.*, 540 F. Supp. 667, 671 (D. Mass. 1982). The Eighth Circuit properly rejected the decision in that case. (Pet. App. 11a.) The decision in *In re McDonnell Douglas Corp. Securities Litigation*, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶98,737 (E.D. Mo. June 22, 1982), also cited by the Eighth Circuit (Pet. App. 11a), was subsequently reconsidered by the trial court and, in accordance with the decision in this case, the claim was dismissed. *In re McDonnell Douglas Corp. Securities Litigation*, MDL No. 448 (E.D. Mo. June 15, 1983).

relies on a statement by the Second Circuit, in *Shapiro* v. *Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 495 F.2d 228, 240 (2d Cir. 1974), for the contrary proposition that there is a general duty "to the investing public." (Pet. 15.) However, to the extent that concept was still viable in the Second Circuit after its decision in *Wilson* v. *Comtech Telecommunications Corp.*,[3] it was specifically rejected in *Dirks* v. *SEC*, 51 U.S.L.W. 5123 (July 1, 1983) (No. 82-276). In *Dirks*, this Court stated that *Chiarella* repudiated "any notion that all traders must enjoy equal information before trading: '[T]he "information" theory is rejected.'" 51 U.S.L.W. at 5126.

Dirks and *Chiarella* established that the duty to disclose or abstain from trading arises, instead, from "a specific relationship between two parties" and there is no such duty when the person who trades on inside information is "not a person in whom the sellers [of the securities] had placed their trust and confidence." *Dirks* v. *SEC*, 51 U.S.L.W. 5123, 5125 (July 1, 1983) (No. 82-276), *quoting Chiarella* v. *United States*, 445 U.S. 222, 232, 233 (1980).

The sellers of the securities at issue here—the call options issued by the Options Clearing Corporation—had no relationship whatever with General Dynamics. The Eighth Circuit was correct in holding that General Dynamics owed them no duty of disclosure.

The Eighth Circuit did not require privity as petitioner asserts. (Pet. 13.) It held that there must be some connection between the plaintiff and defendant. Where there is no fiduciary relationship and there is no transactional nexus, there can be no recovery under Section 10(b). The decisions in both *Chiarella*, 445 U.S. at 226-229, and *Dirks*, 51 U.S.L.W. at 5125, adopt the rationale for the disclose or abstain rule

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[3] *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 95 (2d Cir. 1981), held that the duty to disclose runs only to those persons who trade contemporaneously with the defendant because only they can suffer "the disadvantage of trading with someone who has superior access to information."

articulated in *In re Cady, Roberts & Co.*, 40 S.E.C. 907, 912 (1961). As the dissenting justices in *Dirks* noted, 51 U.S.L.W. 5130 n. 8, *Cady, Roberts* stated that the obligation to disclose or abstain rested on two principal elements: the fiduciary relationship, discussed above, and: "the inherent unfairness involved where a party takes advantage of such information knowing it is unavailable to those with whom he is dealing." 40 S.E.C. 907, 912 (1961) (footnote omitted). Even under the more expansive view of Rule 10b-5 liability contained in the *Dirks* dissent, the harm which is to be prevented is: "the inherent unfairness to the shareholder caused when an insider trades with him on the basis of undisclosed inside information." 51 U.S.L.W. 5130 n. 8. *See also Elkind* v. *Liggett & Myers, Inc.*, 635 F.2d 156, 169 (2d Cir. 1980); *Fridrich* v. *Bradford*, 542 F.2d 307, 318-320 (6th Cir. 1976), *cert. denied*, 429 U.S. 1053 (1977).

As the Eighth Circuit noted, under this theory, the sine qua non of a Section 10(b) claim is "unauthorized trading of securities in the same market as the persons damaged." (Pet. App. 8a-9a.) The Eighth Circuit specifically ruled that there could not have been such an informational imbalance between traders here:

> [I]t is clear there is only a speculative nexus between Laventhall, as an options holder, and the corporate insiders dealing with stock. Regardless of General Dynamics' nondisclosure and purchase of stock there was no informational imbalance in the separate transactions performed by the corporation and Laventhall because they in no way can be said to have been "trading" with one another.

(Pet. App. at 13a.)

As petitioner must acknowledge, there are ample existing sanctions for unlawful inside trading in stock. (Pet. 7.) The real question posed here is who may state a claim for monetary recovery for asserted improprieties. The Eighth Circuit was clearly correct in holding that those who neither traded

nor were in any way connected with the defendant have too remote a claim to such monetary recovery. (Pet. App. 10a.) *Fridrich* v. *Bradford*, 542 F.2d at 321 (6th Cir. 1976).

II.

REVIEW BY THIS COURT IS PREMATURE BECAUSE THERE IS NO CONFLICT AMONG THE CIRCUITS AND THERE IS PROPOSED LEGISLATION ON THIS ISSUE.

No other circuit court of appeals has addressed the question whether options traders can state a claim for civil damages against insiders who trade only in stock.[4] There is, therefore, no existing conflict. Nor is there any reason to conclude that, if this issue is presented, the other circuit courts will settle into a pattern of conflict. The decision below was not only fully consistent with this Court's rulings in *Chiarella* and *Dirks*, but also with the rationale underlying the Sixth Circuit's decision in *Fridrich* v. *Bradford*, 542 F.2d at 320-321, which held that where there is no trading connection between the plaintiff and defendant there can be no liability, and the Second Circuit's decision in *Wilson* v. *Comtech Telecommunications Corp.*, 648 F.2d 88, 94-95 (2d Cir. 1981), which held that the duty to disclose runs only to persons who trade contemporaneously with the insider. Review by this Court would therefore be premature.

Moreover, the petitioner's most frequently stated concern is the asserted potential for abuse by insiders improperly trading in options. (Pet. 7, 9-10, 12.) That issue should only be addressed in a case in which there has been record development of pertinent facts. There was no options trading by General Dynamics here and therefore no factual basis for such record development; the issue was not presented to nor addressed by the Eighth Circuit or the district court. The only other court which has been presented with actual insider trading in options held that the transactional nexus between

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[4]See n. 2 at p. 5, *supra*.

traders in the options and insiders trading in the same options at the same time was sufficient to sustain a Section 10(b) claim against a preliminary attack on the pleadings. *O'Connor & Associates* v. *Dean Witter Reynolds, Inc.*, 559 F. Supp. 800, 803-804 (S.D.N.Y. 1983). The Eighth Circuit's decision in this case is not inconsistent with that ruling.

Finally, the Congress has before it H.R. 559, 98th Cong., 1st Sess. (1983), which is substantially identical to S. 910, 98th Cong., 1st Sess. (1983), and is entitled "The Insider Trading Sanction Act of 1983." It would specifically impose sanctions for improper insider trading in options. (The Bill is reproduced in full in the Appendix to this Brief.) The Bill covers options trading in direct response to the Thomas C. Reed case, discussed by petitioner. (Pet. 9-10; 49 Sec. Reg. Rep. Bull. 3 (P-H) (April 6, 1983).) Hearings have been conducted on this Bill. 72 Daily Exec. Rep. A-5 (BNA) (April 13, 1983). The scope of the Securities Acts remedies is best resolved by the legislature.

Review by this court is not warranted.

CONCLUSION

The petition for a writ of certiorari should be denied.

Respectfully submitted,

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APPENDIX

H.R. 559, 98th Cong. 1st Sess. (1983)

A BILL

To amend the Securities Exchange Act of 1934 to increase the sanctions against trading in securities while in possession of material nonpublic information.

Be it enacted by the Senate and House of Representatives of the United States of America in Congress assembled,

Section 1. This Act may be cited as "The Insider Trading Sanctions Act of 1983".

Sec. 2. Section 21 of the Securities Exchange Act of 1934 is amended by redesignating subsection (d) as subsection (d)(1), and adding at the end thereof the following new paragraph:

> "(2) Whenever it shall appear to the Commission that any person has violated any provision of this title or the rules or regulations thereunder by purchasing or selling a security while in possession of material nonpublic information in a transaction (A) on or through the facilities of a national securities exchange or from or through a broker or dealer, and (B) which is not part of a public offering by an issuer of securities other than standardized options, the Commission may bring an action in a United States District Court to seek, and the court shall have jurisdiction to impose, a civil penalty to be paid by such person, or any person aiding and abetting the violation of such person. The amount of such penalty shall be determined by the court in light of the facts and circumstances, but shall not exceed three times the profit gained or loss avoided as a result of such unlawful purchase or sale, and shall be payable into the Treasury of the United States. If a person upon whom such a penalty is imposed shall fail to pay such penalty within the time prescribed in the court's order, the Commission may refer the matter to the Attorney General who may recover such penalty by action in the appropriate United States Dis-

trict Court. The actions authorized by this paragraph may be brought in addition to any other actions that the Commission or the Attorney General are entitled to bring. For purposes of section 27 of this title, actions under this paragraph shall be actions to enforce a liability or a duty created by this title. The Commission, by rule or regulation, may exempt from the provisions of this paragraph any class of persons or transactions."

Sec. 3. Section 32 of the Securities Exchange Act of 1934 is amended by striking out "$10,000" in subsection (a) and inserting in lieu thereof "$100,000".

Sec. 4. The amendments made by this Act shall become effective immediately upon enactment of this Act.